In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 476

W. THOMAS DAVIS, ELIZABETH LLOYD DAVIS, CAROLYN L. DAVIS AND PHILIP CAROL DAVIS AND CAROLYN LYLE DAVIS, AS EXECUTORS OF THE ESTATE OF M. PHILIP DAVIS, DECEASED, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In 1953 petitioners bought for $890,000 a lemon orchard and associated assets having a fair market value of $1,036,000. They immediately sold the unmatured crop growing in the orchard for $238,000. The sole question here is the proper amount of the total purchase price of the orchard that represents its cost in determining petitioners' gain upon the sale of the crop.

In their 1953 income tax returns, petitioners reported no gain on the sale, taking the view that

275-627—67

their cost was the same as price they received for the crop. The Commissioner asserted that the cost was $34,841 and determined a deficiency accordingly. In petitioners' suit for a redetermination, the Tax Court agreed with petitioners' valuation of the lemon crop at its sales price less the cost of cultivating it to maturity. However, that court rejected petitioners' argument that the crop should be treated as a "quick" asset, such as cash, with its cost therefore considered equal to its fair market value. Instead, the Tax Court held that since the fair market value of the orchard exceeded its purchase price, that price, less cash and receivables, should be allocated among the other assets, including the crop, in proportion to the relative fair market value of each. The balance of the purchase price to be allocated, $662,000, was 64 percent of the fair market value of the assets purchased, $1,036,000. Accordingly, the Tax Court found that petitioners' cost of the lemon crop was 64 percent of its fair market value of $213,000, plus the cost of cultivation,[1] or $136,000, and that they realized $102,000 gain on its sale (Pet. B-21—B-31). On appeal the court of appeals affirmed *per curiam* (Pet. A-1).

The decisions below are correct; there is no conflict, and no occasion for review by this Court.

The decision in this case is wholly in accord with the general rule, that where a bundle of assets is

[1] The Tax Court accepted the taxpayers' valuation of $238,000 for the lemon crop, but it adjusted that value by $25,000, representing the cost to the taxpayers of maintaining the orchard until the fruit matured. (Pet. B-27—B-30.)

purchased for a lump sum price, and the parties have not agreed in the contract of sale upon a specific allocation of the purchase price to the various assets acquired, the cost of each asset should be determined by apportioning the purchase price on the basis of the relative fair market values of each. *E.g.*, *Commissioner* v. *American Liberty Oil Co.*, 127 F. 2d 262, 263–264 (C.A. 5), certiorari denied, 317 U.S. 648; *United States* v. *Mattison*, 273 F. 2d 13, 21 (C.A. 9).

Petitioners contend (Pet. 6–7) that the decision below attributes income on the basis of the value of the fixed assets that they did not sell but retained. This contention is fallacious. The taxpayers were not taxed for a gain which they did not realize. The increase in their 1953 taxes resulted solely because they bought a bundle of assets at a bargain and resold part of them at their true value. The resulting income is simply the measure of that bargain applied to the part of the bundle that was sold.[2]

Nor is there merit to the contention (Pet. 6–12) that the decision in the present case conflicts with other decisions which have permitted a taxpayer to

[2] Petitioners' position is equivalent to an argument that they should not be required to recognize gain from the sale of one of the purchased assets, e.g., the lemon crop, if the selling price is less than the cost of the entire bundle. Such a contention is contrary to the fundamental annual accounting principle that underlies the federal income tax system—if part of the assets are disposed of during the taxable year, a taxpayer may not defer the recognition of gain until they have recovered their entire cost of the assets. *Heiner* v. *Mellon*, 304 U.S. 271, 275–276.

allocate the purchase price first to those assets that are equivalent to cash. The courts below did not disturb petitioners' allocation of $228,000 of the purchase price to cash and other quick assets (Pet. B–15, B–22); the only issue is whether an unmatured lemon crop is the equivalent of cash. The rationale permitting a purchaser to allocate an equal part of the purchase price to a quick asset is that a seller ordinarily does not sell cash or the immediate right to receive cash at a discount, and therefore a purchaser must have paid the full face amount for an asset that is equivalent to cash. That the Tax Court correctly held (B–22—B–30) an unmatured lemon crop is not the same as cash is indeed demonstrated by *F. & D. Rentals, Inc.* v. *Commissioner,* 365 F. 2d 34 (C.A. 7), certiorari denied, 385 U.S. 1004, the very case petitioners claim to conflict with the present case. In that case a taxpayer had purchased the operating assets of a business for $300,000 less than book value. The parties agreed that the purchase price should be apportioned to the assets in a manner that allocated the entire $300,000 reduction in book value among the fixed assets. The Tax Court and the Seventh Circuit held that the finished inventory and work in progress was not equivalent to cash, and upheld the Commissioner's allocation of part of the reduction in book value to these items as well as to other assets. In the present case the lemon crop has the same economic

function as the inventory and unfinished goods in *F. & D. Rentals.*[3]

Respectfully submitted.

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[3] Contrary to petitioners' contention (Pet. 8, 9, 11), the decision below does not upset previous law, as enunciated in O.D. 714, 3 Cum. Bull. 49 (1920). O.D. 714 merely states in general terms that where a taxpayer purchases land on which crops are growing and later sells the crops, the income realized is the excess of the net selling price over the cost of the crops or, if no part of the purchase price was assigned to the crops, the fair market value of the crops at the time of purchase. Other taxpayers have recognized that the purchase price and fair market value of all assets acquired is to be taken into consideration in determining the cost to the purchaser of an unmatured crop, when the total price is less than the fair market value of all assets purchased. See *Edward* v. *Commissioner*, decided October 28, 1953 (P–H Memo T.C., par. 53, 344). Moreover, if O.D. 714 were read as supporting petitioners' position, it would then violate the annual accounting principle, see footnote 2, *supra*, and would not be binding on the Commissioner. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 183–186.

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